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January 31, 2014

Mr. Robert E. Feldman  
Executive Secretary  
Attention: Comments/Legal ESS  
Federal Deposit Insurance Corporation  
550 17th Street NW  
Washington, DC 20429

Legislative and Regulatory Activities Division  
Office of the Comptroller of the Currency  
400 7<sup>th</sup> Street, SW  
Suite 3E-218, Mail Stop 9W-11  
Washington, DC 20219  
Docket ID OCC-2013-0016

Mr. Robert deV. Frierson, Secretary  
Board of Governors of the Federal Reserve System  
20th Street and Constitution Avenue NW  
Washington, DC 20551  
Docket No. R-1466

Re: Proposed Rule — Liquidity Coverage Ratio: Liquidity Risk Measurement,  
Standards, and Monitoring

Dear Sirs and Madams:

This letter is in regard to the notice of proposed rulemaking that would mandate minimum liquidity requirements for covered institutions and certain non-bank financial companies ("NPR"). It is being sent on behalf of Federated Investors, Inc. ("Federated"). Federated is one of the largest investment management firms in the United States and the third largest manager of money market funds ("MMF"s).

Federated agrees with the underlying goal of the NPR. As the recent financial crisis clearly demonstrated, a lack of sufficient liquidity in the financial system has the potential to disrupt the financial markets and damage our economy. However, it is important that regulatory liquidity requirements be carefully drawn in order to prevent unintended consequences that could actually increase risks in the financial system. In order to avoid these adverse impacts, it is critically important that the regulation accurately recognizes the liquidity value of all types of assets. It is also important that the regulation does not encourage covered companies to invest in higher yielding but riskier assets in lieu of safer assets whose liquidity value is underestimated.

We are concerned that with respect to MMFs the NPR may have the adverse effects noted above. We are providing this comment letter to explain our concerns and to offer our suggestions to improve the regulation.

#### I. High Quality Liquid Assets

Under the NPR, a covered organization must maintain sufficient amounts of high quality liquid assets (HQLA) to withstand a run on the institution during periods of severe economic stress. The length of the test is 30 days for the very largest companies, and 21 days for bank holding companies with between \$50 billion and \$250 billion in consolidated assets. To test the sufficiency of the liquidity reserve, the LCR specifies a “stress test” with stipulated deposit outflows, draw downs, and other liquidity demands.

The NPR specifies that HQLA must be easily and immediately convertible into cash with little loss of value. The asset must be unencumbered and free of any impediment that would prevent the covered institution from converting the asset to cash, and cannot be used as a hedge against another position. An asset that is pledged, explicitly or implicitly, to provide credit enhancement to any position cannot be used. Further, assets that are obligations of financial companies, including all investment companies, may not be considered HQLA, *even if all of the other standards are met*. Thus, under the proposal, shares of all money market funds, including money market funds managed by Federated, cannot be considered HQLA.

High quality liquid assets are divided into three classes or levels. Level 1 assets can be used to meet the liquidity test without limit. Level 2A assets can be counted for liquidity purposes, but are subject to a 15 percent haircut. Level 2B assets are subject to a 50 percent haircut. In addition, the aggregate amount of Level 2A and 2B assets cannot equal more than 40 percent of the total required HQLA, and Level 2B assets cannot count towards more than 15 percent of the total required amount.

Level 1 assets include liquid and readily marketable securities issued or guaranteed by a foreign sovereign entity, provided the security has a 0 risk weight under the Basel capital rules, and the issuer’s obligations have a proven track record as a reliable source of liquidity during stressed conditions. Countries that have a 0 risk weight under the Basel capital rules include such diverse jurisdictions as Bermuda, Bhutan, Cayman Islands, Estonia, France, Germany, Hungary, Iceland, Ireland, Italy, Portugal, and Spain.

Level 2A assets consist of debt securities issued by Government Sponsored Entities, such as Fannie Mae or Freddie Mac, marketable and liquid securities issued by sovereigns and multinational development banks that are assigned a 20 percent risk weight under the Basel capital rules. Level 2A assets are subject to a 15 percent haircut.

Level 2B assets are liquid and readily marketable and publicly traded corporate debt securities issued by a non-financial company that is determined to be investment grade and is issued by an entity that has a proven track record as a reliable source of liquidity during stressed market conditions. Level 2B assets also include publicly traded corporate equity securities of non-financial companies that are included in the S&P 500 Index, or similar index, that indicates the securities are liquid and readily marketable. The issuing company must have a proven track record as a reliable source of liquidity during stressed market conditions. Level 2B assets are subject to a 50 percent haircut.

In addition to the prescribed haircuts, the aggregate amount of Level 2A and 2B assets cannot exceed 40 percent of the total required HQLA, and Level 2B assets cannot exceed 15 percent of the required amount of HQLA. Thus, for every dollar of required liquidity, after taking the required haircuts, Level 2B assets cannot count for more than 15 cents of the liquidity requirement, and the total of Level 2A and Level 2B cannot count for more than 40 cents of the liquidity requirement.

We understand that there is concern among some of the regulators that the Reserve Fund “broke the buck” in 2008 due to its significant investment in Lehman Brothers debt instruments.<sup>1</sup> However, in 2010, the Securities and Exchange Commission amended its regulations to deal with, among other things, the concerns raised by the Reserve Fund failure. Under the amended rules, MMFs must, among other limitations, invest only in securities that mature within 397 calendar days from the date they are purchased, and meet very strict liquidity and portfolio diversification requirements. These requirements include: (i) satisfying daily and/or weekly Liquid Asset standards whenever they acquire a security; (ii) limiting securities that cannot be sold in the ordinary course of business within seven calendar days at approximately the value ascribed to them by the fund to 5 percent of holdings; and (iii) maintain sufficient liquidity “to meet reasonably foreseeable shareholder redemptions.”<sup>2</sup> In practice, this has resulted in prime MMFs holding well over 40 percent of their portfolios in seven-day liquid assets, a percentage roughly triple the percentage redeemed from prime MMFs in the seven days after Lehman failed in September 2008.<sup>3</sup> The greatly enhanced liquidity required by the 2010 amendments allows MMFs to meet extraordinarily high levels of redemptions from internal portfolio cash without

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<sup>1</sup> In the 40-year history of MMFs, only two funds (both institutional) have failed to return \$1.00 per share. Of those two instances, only the failure of The Reserve Primary Fund in 2008 was accompanied by significant redemptions in other institutional MMFs. See, Comment Letter dated January 15, 2013, submitted to the Financial Stability Oversight Board by Vanguard at pages 1, footnote 3. The comment letter is available at <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0048>.

<sup>2</sup> See amended rule 2a-7(c)(5)(ii)-(iii). See also amended rule 2a-7(a)(8) (defining “daily liquid assets”); 2a-7(a)(32) (defining “weekly liquid assets”); (infra notes 229-243) and accompanying text. “Total assets” means with respect to a money market fund using the amortized cost method, the total amortized cost of its assets and, with respect to any other money market fund, the total market-based value of its assets. See amended rule 2a-7(a)(27). SEC Rel. No. 29132.

<sup>3</sup> J. Macey, “Money Market Funds: Vital Source of Systemic Stability” at 8, (2012), (hereinafter “J. Macey”) See also the Fitch Study of MMF Shadow NAV (June 14, 2012), available at: <http://www.fitchratings.com/web/en/dynamic/articles/Study-of-MMF-Shadow-NAV-Shows-Stability.jsp>.

selling assets. This liquidity also enables MMFs to pay cash to redeeming investors even if the underlying money markets become illiquid.<sup>4</sup>

Moreover, MMFs are generally prohibited from investing more than 5 percent of their total assets in securities from any one issuer, and are prohibited from allocating more than 3 percent of fund assets to nongovernmental securities that are not in the highest rating category. Perhaps most critically, MMFs must have “a dollar-weighted average portfolio maturity appropriate to its objective of maintaining a stable net asset value per share” and in no event can an MMF have a dollar-weighted average maturity that exceeds 60 days.<sup>5</sup>

In light of the new safeguards imposed by the SEC, the failure of the NPR to allow investments in MMFs to be used to satisfy the liquidity standard appears arbitrary. It certainly makes little sense to allow corporate debt and corporate equity to be included in Level 2B, and at the same time prohibit any liquidity credit for MMFs backed by a very diverse pool of highly rated short-term corporate debt instruments that are more liquid than the corporate debt that can be counted.

If the agencies are not convinced that the new regulations are sufficient to ameliorate their concerns regarding the stability of MMFs, any remaining doubts could be relieved by applying a suitable haircut to the value of investments in MMFs. Allowing Prime MMFs to be viewed as Level 2B assets would subject these investments to a 15 percent haircut, which far exceeds any potential loss in value.<sup>6</sup> A study by the Investment Company Institute found that following the failure of Lehman Brothers, Inc., at the height of the financial panic, the vast majority of prime MMFs saw their per-share market values fall very little, and no MMF in their study has a decline in value below \$0.995 in excess of 10 basis points. Level 2B treatment would provide a 15 percent discount, which is more than sufficient to cover any liquidity risk posed by MMFs.

## II. Government MMFs

Federated is also concerned that the regulation appears to treat all types of money market funds the same, and does not differentiate among prime funds, tax exempt funds, and Government funds. While all three types of funds have a high degree of liquidity and should be

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<sup>4</sup> J. Macey at 8.

<sup>5</sup> SEC Rel. No. 29132, at 185.

<sup>6</sup> According to Professor Macey, following the Lehman Bros. failure, the “Primary Fund’s NAV fell just three pennies, to \$0.97 a share. This drop occurred in two stages. First, the NAV went to \$0.99 when the 1% Lehman position was priced at zero. Second, shareholder redemptions caused a further dilution of less than two additional cents” J. Macey at 20

recognized as high quality liquid assets, as discussed above, Government funds should be recognized as a unique product that provides the highest degree of liquidity other than cash.

Government MMFs are restricted to holding only U.S. Government debt, such as Treasury securities and agency securities backed by the full faith and credit of the United States. Some Government funds may also invest in securities issued by Fannie Mae and Freddie Mac, or the Federal Home Loan Bank System. While these instruments are not always explicitly backed by the United States Government, the market perceives them to be close equivalents to Treasury securities.

Immediately following the failure of Lehman Brothers, Government MMFs saw a large influx of funds from investors seeking the safety of Government-backed obligations.<sup>7</sup> Total assets in Government MMFs increased by 40 percent during the period following the Lehman Brothers failure.<sup>8</sup> Between September 10, 2008 and October 15, 2008, total assets held by Government MMFs increased from \$906 billion to \$1.359 trillion.<sup>9</sup> According to the Investment Company Institute, the financial panic also saw an increase in the net asset value of Government MMF shares to above \$1.00 per share, and remained in excess of \$1.00 throughout 2009.<sup>10</sup>

Based on this evidence, and the logical conclusion that an investment backed by Government obligations will be viewed by the markets as a safe haven in times of stress, we believe that Government MMFs should be an HQLA without the need for any haircut. There should be no question that Government MMFs are as liquid, if not more liquid, than foreign country debt, especially in light of the current turmoil in the European and World markets. By allowing foreign debt (that has a 0 risk-based capital weight under Basel III) to be used without limitation in meeting liquidity requirements, but not allowing Government MMFs to be used at all, the NPR will encourage covered companies to make riskier investments in foreign debt obligations, which is contrary to the goal of a safer financial system in the U.S. Certainly, debt issued by Bhutan shouldn't be afforded more favorable liquidity treatment than a regulated investment company investing in short-term U.S. Government securities. We, therefore, strongly recommend that Government MMFs be included as Level 1 assets.

### III. Tax-Exempt Funds

Tax-exempt MMFs hold short-term debt instruments issued by State and local governmental entities. During the financial crisis, the markets viewed Tax-Exempt MMFs differently than Prime MMFs. Thus, during the two weeks following the failure of Lehman

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<sup>7</sup> Melanie L. Fein, Money Market Funds, Systemic Risk and the Dodd-Frank Act, Presentation before the American Enterprise Institute 8 (June 28, 2012).

<sup>8</sup> Letter dated June 1, 2012 to SEC Chairman Mary Schapiro from Tony Carfang and Cathy Gregg, Treasury Strategies, Inc. (available at <http://www.sec.gov/comments/4-619/4619-188.pdf>).

<sup>9</sup> Id.

<sup>10</sup> ICI Research Perspectives, Vol. 19, No.1 (January 2013) at 27.

Brothers, the 10 largest tax-exempt funds had only a 1.3 percent and 3.6 percent decline in assets respectively.<sup>11</sup> Further, Tax-Exempt Funds are primarily exposed to State and local governmental entities, and the creditworthiness of these issuers does not correlate with financial market panics that may impact commercial issuers. Thus, Tax-Exempt MMFs are subject to different risks than Prime or Government Funds, and the presence of these investments as HQLA will provide a diversification that will enhance the protection against a liquidity run that is the ultimate goal of the regulation. Based on this analysis, we suggest that the agencies consider allowing Tax-Exempt MMF shares to be used to satisfy at least a portion of a covered entity's liquidity needs.

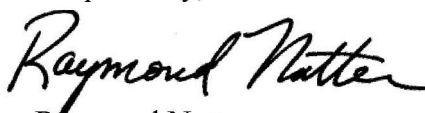
#### IV. Runoff Rate for Secured Funding

Under the NPR, covered companies must assume that the company's secured funding will runoff at prescribed rates. The NPR bases the required runoff rates on the character of the collateral securing the loan to the covered company. If the loan to the covered company is secured by Treasury obligations, other sovereign debt, corporate bonds or equities of large non-financial companies, the required runoff rate is reduced. However, when a bank or other covered company posts shares of a money market fund as collateral, no reduction in runoff is recognized.

For the reasons explained above, we believe that Government, Prime and Tax-Exempt MMFs should be considered HQLA. However, *even if* MMF shares are not considered HQLA for purposes of meeting the liquidity requirement, the value of MMF shares as collateral for loans to a bank or other covered entities should not be ignored. It simply does not make sense to use the same runoff rate that applies to unsecured debt when a loan is, in fact, secured by highly credit-worthy and liquid MMF shares. We believe that a loan to a covered company secured by Government MMF shares should have the same runoff rate as a loan secured by Level 1 assets, and a loan secured by other types of MMFs should have the same runoff rate as a loan secured by Level 2A assets.

We thank you for providing an opportunity to comment on the proposed liquidity regulation, and for considering the comments contained in this letter. If you have any questions or would like follow-up documentation, please feel free to contact me at (202) 463-6040.

Respectfully,



Raymond Natter

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<sup>11</sup> Comment Letter dated January 15, 2013, submitted to the Financial Stability Oversight Board by Vanguard at pages 6-7, available at <http://www.regulations.gov/#!documentDetail;D=FSOC-2012-0003-0048>.